

# The Outlook for the Metropolitan Area

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Much of the discourse about regional and local economic development strategies in the United States over the past twenty-five years has looked like a search for general rules. Very few such rules have emerged, in part because—like all policy debates—there have been large inputs of ideology and self-interest, as well as professional inquiry, but in part because the appropriate strategies really are time- and place-specific. The strategies that are right depend on, first, the diagnosis of the economic problems and potential of that region or city at that time and, second, an assessment of just what it is that intervention can achieve in the circumstances of time and place. The authors of the other papers presented at this conference deal systematically and exhaustively with the fundamentals of the New York region's economic conditions and pros-

pects, but it is essential that this paper start with an exposition of the economic setting for the discussion of policy intervention that comprises the bulk of the paper.

## THE NEW YORK ECONOMY IN THE LONG TERM: THE PAST

Twenty years ago, most observers projected continual decline in the New York economy, and almost any economic development strategy seemed pointless.<sup>1</sup> Indeed, in the mid-1970s—beginning *before* the fiscal crisis of 1975—the city and state governments of New York were making virtually no capital expenditures remotely related to economic development. Instead, capital budgets were devoted to subsidized housing, public office buildings, and current operating expenditures like “transit fare stabilization.” The scattered tax incentive measures (in the midst of frequent tax increases) involved extremely deep subsidies, sometimes providing for recovery of more than 100 percent of the private investment from reductions in taxes that would have been payable in the absence of the new invest-

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ment, in addition to exemption from much of the taxes that should have been triggered by the investment.

The first major commercial building project after the slump—Donald Trump's conversion of the old Commodore Vanderbilt Hotel into the Grand Hyatt—involved incentives that virtually eliminated any risk for Trump and his partners. In contrast, less than ten years ago, projections were so optimistic that many critics of the city government saw no need for public subsidies or tax preferences to foster economic growth.<sup>2</sup> The critics often urged not only the elimination of subsidies but also increases in business property taxes. Although at the extremes of despair and optimism no economic development strategies may make sense, between those extremes the long-term economic prognosis does make considerable difference in prescribing economic development strategies.

It helps, in thinking about the economic future of the region, to briefly review the past. New York's economic history since the completion of the Erie Canal in 1825 has been one of almost continuous rise and fall of particular industries and sectors, with the sectors that were the well-springs of the economy in one generation fading and being displaced by new sectors (see Hoover and Vernon [1959] for the classic statement of this idea). Through the 1940s, the result of the displacement process was net growth in the aggregates (employment being the only one that really was measured in those years): the increases in economic activity in the rising sectors, together with the multipliers in local consumer-serving activities, exceeded the declines in the shrinking sectors. In the 1950s, for the first time ever in a period of national economic prosperity there was almost no net growth in employment in New York City, as fairly strong growth in office activities was balanced by the onset of substantial losses in a wide range of manufacturing and other goods-handling activities. There was, however, considerable growth in the rest of the New York region.

The Vernon study of the economic future of the New York region, published in 1959 and 1960, projected more of the same through 1985, but with net growth in New York City from very strong office activities and a large consumer-sector multiplier and considerable growth in the rest of the region.<sup>3</sup> During the 1960s, that is exactly

what happened: the decline in goods handling within the city continued apace; the securities industry grew rapidly, as did most producer services; both residential and office construction were strong; and public expenditure for capital projects, current operations, and transfer payments increased very rapidly indeed.<sup>4</sup> New York City, unlike nearly all other large central cities in the Frostbelt, had significant employment gains during the 1960s. The rest of the region did very well indeed, although manufacturing employment did not increase at the rate the Vernon study had forecast.

The 1969-77 slump is surprisingly poorly documented, perhaps because its dramatic qualities were overshadowed by the city government fiscal crisis of 1975. The trigger was a national recession combined with the end of a bull securities market. Employment in the securities industry contracted substantially, and was flat for most other financial services. New York's decline continued after the national economy turned around in 1970, in part because the long boom in office building construction had ended. In some ways, the early years of the slump were like the 1980s slump in the "oil-patch" Sun Belt cities: a sharp contraction in the main local specialization and the inevitable cyclical end of a construction boom as the vacancy rates rose. However, in New York City, the long decline in goods-handling activities continued, preventing any early recovery in total employment. Moreover, unlike the 1980s, there was no real lift from the tourism and entertainment industries (Broadway had its worst seasons in history in the mid-1970s).

The rest of the region began to recover after 1971, but—along with the city—was set back by a new and much more severe national recession in 1974. The suburban economies were also depressed by the lower level of personal income associated with Manhattan central business district jobs held by commuters living in the suburban counties.

As is well known (from the history of the fiscal crisis), state and local government expenditure continued to increase rapidly in the first half of the 1970s. That was mainly in the form of increased transfer and interest payments and higher levels of compensation (New York City

General Fund spending increased by close to one-third in real terms between fiscal years 1969 and 1976) but only small increases in employment. Indeed, the central city seemed to have run out of job-growth sectors, and few observers saw much prospect for trend reversals, *ever*. To some extent, the fiscal profligacy of the period between late 1971 and early 1975 can be attributed to this doomsday view: if the city, as a place, was doomed to continuous decline, why should the city government not do whatever it could to cushion the decline in the short run? (The answer, of course, is that the short run *had* to be very short—lenders could and did realize that the prospects for repayment of the short-term debt were becoming dim—and that the fiscal profligacy itself encouraged private-sector flight.)

After 1977, there was a reversal, and recovery, which started slowly but accelerated, until 1989. In essence, although goods-handling employment continued to decline in the central city, virtually all of the other 1969-77 trends were reversed. Within the city, the engines of growth were the financial services industries, other high-end producer services, the media industries, tourism (especially the increase in high-spending overseas visitors), health services, and a new construction boom. The rest of the region also did well from these same sources, but in addition there was the effect of the marked increase in defense spending that began in 1979; the New York region turns out to have been more dependent on defense procurement than most observers had noticed.

State and local government public expenditure trends were also reversed in the initial years of recovery, and there were numerous cuts in tax rates. The New York City General Fund expenditure actually declined in real terms (by about 30 percent) between fiscal years 1976 and 1983, but climbed steeply once again after fiscal 1983. A similar but less pronounced pattern occurred in New York and New Jersey state government expenditures.

#### THE NEW YORK ECONOMY IN THE LONG TERM: THE FUTURE

The decline in the region's economy that began in 1989 has some uncomfortable similarities with the slump that

began twenty years earlier. Once again, employment in the securities industry was cut back sharply, and the office building construction boom petered out. Once again, there have been no obvious major sources of expansion to counter the gloom. And once again, there have been serious budgetary problems, this time involving the New York State government even more than the New York City government, addressed (in the case of the state government) by methods that remind people of 1971-75.

Even the differences between the first half of the 1970s and the first half of the 1990s with respect to the region's economy are disquieting, for the most part. The sharp declines in defense-related employment (especially in Long Island and Connecticut), weakness in other manufacturing industries in the region outside the older centers, contraction in employment in commercial banking and (prospectively) in health services, and the effects on the region of corporate downsizing were not phenomena of the earlier period, but are very much present today. The only current economic conditions that are comfortably different from the earlier period are related to (1) globalization—the relatively greater importance of international financial and business services in the region's economy and the growth of tourism; (2) some shrinkage in the cost differentials between the region and its main competitors (in part, too, associated with globalization, because more of the competitors are very high-cost cities in Asia and Europe rather than low-cost cities in North America); and (3) the absence of spectacular financial mismanagement by the New York City government to frighten business away.

Were the pessimists of the mid-1970s right in believing that the long-term prospects were, and are, dismal, with the 1977-89 period an aberration? Probably not; it seems to me as likely today that the New York economy can do well over the long term, as it did to Vernon in 1960.<sup>5</sup> As in 1960, the region has a favorable "mix" of industries, that is, substantial concentration in sectors likely to grow worldwide. Over the long term, the worldwide demand for high-end financial and other business services will continue to be very strong. No doubt, the region will lose "shares" of the rapidly growing sectors to other places, as the places where economies of agglomeration can

be achieved multiply. However, while more and more of today's high-end services will be better accommodated in smaller places, new specialized types will develop and—as in the recent past—will seek very central locations, such as New York, London, and Tokyo.

A generation ago, Vernon predicted that by improving transportation technology, both decentralization and centralization of headquarters and other business and financial services would be facilitated. A few contemporary scholars, notably Moss (1987), have been pointing out that changes in communications technology are having the same effect. It would be ridiculous in the extreme to postulate no improvements in communications technology from here on, or to postulate that whatever further improvements there are will work only to decentralize: both propositions are at odds with experience.

The advanced services show up in a good many places in the Standard Industrial Classification, not only in classes 60-63, 73, and 89. Much of New York's economy has been transformed, under the names of traditional industry groups, somewhat in the way that so much in eastern Michigan was transformed by the mid-1950s into branches of the auto industry while continuing to bear names of quite different industries. However, unlike Michigan's auto industry, New York's advanced services industry is not really a single industry; it is highly diverse and not dependent on swings in demand that are almost completely convergent in timing. Moreover, the product mix changes rapidly.

Often in the past, and today again, some of the pessimism for the long term arises because it seems inconceivable that there can be much further growth in the demand for those services now being produced (in the city or even in the country or world): If productivity increases, then employment—say, in banking—must decline. It is impossible to predict exactly what services (or goods) any sector will be producing fifteen or twenty years hence; history shows that it is absurd to assume that growth in a sector will cease because of a surfeit of those services in today's product mix. It is our imagination, rather than the economy, that has long-run problems.<sup>6</sup>

In addition, most of the more traditional sectors

will do marginally better than in the past, in part simply because they are so much smaller and now include cohorts of firms that have adjusted to cost and other adverse competitive factors in the New York location. To some extent, they will be bolstered by the continuing high level of overseas immigration, as has been the case since the late 1970s. Moreover, it is difficult to believe that personal incomes will continue to rise substantially without spilling over into New York City retail trade and consumer services.

In a 1996 article in *City Journal*, Professor Edward L. Glaeser of Harvard tells a nonprofessional audience “Why Economists Still Like Cities.” In a superb survey of the evidence, he goes through the traditional arguments in favor of the persistence and growth of large urban concentrations, arguments relating essentially to the higher productivity associated with the economies of agglomeration and coordination, arguments that date far back in the history of economic thought. However, in recent years numerous economists have added new conceptual wrinkles to the arguments and amassed substantial empirical evidence in support of them.<sup>7</sup> The arguments suggest that large city (read, urban area) size is not a disability, despite the spread of economies of agglomeration to smaller cities over time. Glaeser reaffirms the Vernon point that telecommunications cannot replace face-to-face communication, the essence of the New York region's difference from smaller cities and from a good many modestly sized “new-model” cities that have become big cities in the United States in recent decades, such as Phoenix and Charlotte. In such cities, economic activities cluster not to be near one another but because each of them separately finds that city to be advantageous in its climate, low labor costs, accessibility, and amenities: the physical traffic among the office buildings during the course of the working day is startlingly sparse.<sup>8</sup>

In short, the long-term competitive outlook for the New York City economy is not so bleak as to make any economic development strategy quixotic. Moreover, the optimism expressed above is guarded: the projections are for very modest rates of real growth, in employment terms less than 20 percent over twenty-odd years. Such growth rates will not eliminate all economic distress, nor make it

easy for city and state governments to finance generous levels of public services—the two reasons that traditionally make state and city governments intervene to foster growth. Because much central city economic distress is associated with low labor force participation rates even in the face of low rates of unemployment, it may be that even the most effective of economic development strategies will be unable to massively reduce poverty and solve what has been described as the “two cities” problem: a large core of poor people outside the mainstream economy and unaffected by positive economic developments, in the midst of prosperous city economies.

The experience of the 1980s has in fact been interpreted in this way by some economists and most popular writers on the subject. However, most large, old cities had only a few years with low unemployment rates in the 1980s, after years of much higher rates. It seems foolish to forecast that sustained high demand for labor will not affect labor force participation rates over time, thus partly dissolving the two cities problem. Indeed, the optimistic long-run projections generated by widely used econometric models in the late 1980s were made to converge only by pushing labor force participation up sharply in the out years.<sup>9</sup>

#### WHAT INTERVENTION CAN ACHIEVE: THE NEW YORK CONTEXT

The discourse on regional and local economic development, like the discourses on national “industrial policy” and on international trade policy, is dominated by the debate between interventionists and skeptics. To the interventionists, market imperfections legitimize—indeed, demand—active economic development policies, and the growing sophistication of public entrepreneurs makes it likely that they can avoid the egregious mistakes often made in regional economic development in an earlier, more naive era.<sup>10</sup> The skeptics, in contrast, have no confidence in the ability of state and local officials to pick winners rather than losers; to avoid giving away, in tax preferences or more direct subsidies, far more than is necessary to elicit the favorable location decisions; or to build location-affecting elements into general policies concerning education, infra-

structure, and the like.

Among professional economists, the most powerful case for the interventionist position is made by Bartik (1991). Bartik carefully summarizes the evidence from dozens of econometric studies of the effects on state or local economic growth of major policy instruments—notably, differences among the states in taxes and expenditures, as well as the effects of specific economic development programs such as “enterprise zones” and the effects of differences that are only loosely related to public policy, wage rates, and the extent of unionization.<sup>11</sup> He concludes that the effects on growth rates are indeed fairly strong. Much of the study is devoted to an examination of the consequences of local economic growth, which he finds to be strongly positive on both distributive and efficiency grounds, concluding with “two cheers” for interventionist state and local policies.

There are at least two general considerations relevant to the issue of whether interventionist policies are likely to be successful and efficient. The first concerns the size of the place in question. It seems plausible that the larger the place, the better the case of the skeptics. In a small place, highly targeted economic development policy decisions may be made so infrequently that the likelihood of gross error can be reduced substantially. That is, the governmental decision makers should not be overwhelmed by the sheer necessity of negotiating a large number of deals simultaneously, without much scrutiny by anyone else, which seems to have been a real problem in the past at city and state levels in New York. Also, it is easier to make visible changes in the “climate” for location decisions in a small place than in a region like this one, where a multibillion-dollar investment program may not persuade anyone but the technicians that transportation facilities, for example, have in fact been improved. Moreover, the information costs of reaching all or most potential entrepreneurs can be extremely high in a large place. There are frequent reports in this area that most proprietors of small enterprises, actual or potential, are quite unaware of most incentive programs.

So, on this score, skepticism seems a reasonable starting point for considering economic development strat-

egies for the New York region: the burden of proof should be on the advocates of interventionist measures.

However, the case for interventionist policies also depends upon whether or not existing public policies are essentially neutral with respect to economic development. If existing public policies are generally hostile to economic development, then an interventionist posture may be necessary merely to offset the damage that governments are doing.

The fact is that, in the New York metropolitan region, policies are *not* neutral: there is a long tradition of public sector hostility—quite deliberate at times in the past, unintended more recently—to policies that are neutral with respect to economic development. There are regulatory regimes that are, or have been, hostile to new and expanding firms and that raise the prices of producer goods and services. A stark example is the sharp differential between residential and business utility rates under regulation. Over the years, the differentials have been greater in New York State than in most other states, compounding the fact that all rates, residential as well as business, have been very high relative to those in any other state. This discrimination also applies to utility-type services provided by state and local governments, such as excessive “tipping fees” for the use of public landfills by private carters serving business customers, and highway-user taxes and charges on commercial vehicles that are in no way cost-based but are far higher than those on noncommercial vehicles.<sup>12</sup>

The private sector must support an exceedingly expensive public sector, costly for reasons that are not entirely clear. That is, the costs are high even taking into account the high unit costs of density, the conventional wisdom about diseconomies of scale in the production of local public services, the popularity (at least in the past) of explicitly redistributive policies, and what can best be called mindless populism.<sup>13</sup>

The costly public sector is financed by a revenue structure that combines explicit redistributive goals (graduated city and state personal income taxes, among others) and substantial reliance on revenue instruments that are sold as not affecting ordinary households, such as very high

taxes on telephone service, high transaction taxes on real estate transfers (in New York), and imposition of the sales tax on a wide range of intermediate business purchases and high corporate income taxes (in all three states). In reality, of course, such instruments are likely to have zero, or even perverse, distributive results, as well as negative effects on economic development.

The extreme example may be the way the property tax works in New York City (and Nassau County). A combination of state law and local choice (mostly by local law but to some extent in the form of administrative practice) has produced effective tax rates that average above 4 percent for new commercial buildings that are not favored with targeted economic development incentives, about 3 percent for utility properties, and about 2 percent for older commercial properties and for rental apartment buildings, but considerably below 1 percent for homeowner properties, most high-end co-op and condominium apartments, and vacant land.<sup>14</sup> The adverse economic effects of the high rates (anything above 1 percent is high by national standards) are obvious. In addition, the existence of the low-rate classes does not do much for economic development, because the substantial decline in those rates during the 1980s seems to have been capitalized into housing and land prices almost instantaneously. The system is also highly objectionable on distributional grounds: in addition to the much better treatment of owner-occupants than renters, within the residential classes effective tax rates decline systematically with the value of the housing unit.

Given the hostile public policy environment in much of the region, economic development strategies that essentially undo this hostility, perhaps doing no more than restoring a neutral posture, seem a good idea. It is not obvious whether the instruments of these strategies should be highly selective or work across the board—assuming that the state and city governments cannot simply reverse the hostile policies (and there is good reason not to, where the damage has already been done and reversal will result mainly in windfall gains). Across-the-board instruments inevitably will have an element of inefficiency, benefiting firms and households that are nowhere near the margin, in

present-value terms, from the standpoint of location decision making. However, selectivity requires both a high order of insight by officials and considerable bargaining skill.

On the spending side—that is, improving the quality of inputs (for example, infrastructure, labor, current public services) and subsidies to reduce input costs—selectivity seems very inappropriate in New York City, if not in general. Direct input subsidies, notably to lower the cost of capital, have not had an impressive record anywhere, and virtually all such uses in New York City have been failures—subsidies to marginal enterprises that soon collapse. Programs to improve labor quality by offering training that is highly specific to individual firms or industries, on which considerable sums of federal money were spent in the 1970s, have fared no better. In addition, in New York's high-density environment it is difficult to design highly selective improvements in infrastructure or current public services: either most of the benefits spill over to nontargeted users (indeed, sometimes to users whose presence the city has no reason to encourage) or the specific improvement is so confined in scope that there is no perceptible effect on the quality of the service in question.

#### PUBLIC EXPENDITURE AND ECONOMIC GROWTH

General improvement in publicly provided services that are of importance to firms appears to be a superior strategy. The costs of general improvements in educational output or in transport system reliability are of course very high. However, there is no real sense in which the benefits of such improvements can be said to have been wasted entirely, even if the impact on economic development is not readily observable in the short run. It is important in designing this strategy, however, to differentiate between improvements that are producer-oriented and those that are consumer-oriented.

A striking illustration of the difference in the New York area is the inattention in transportation policy to goods movement, relative to the attention given to highway facilities that are closed to trucks, including some roads whose main function is to serve as journey-to-work

routes that parallel rail commuter services, such as the Northern and Southern State Parkways on Long Island and the north-south parkways in Westchester. The importance of this point is heightened when it is recognized that the proportion of goods movement by rail is lower in the New York region than in any other large urban area in North America. There are obvious policy changes that could dramatically lower road transport costs for goods and business services by reversing the priorities in the allocation of road space away from auto commuting.<sup>15</sup>

There is a considerable empirical literature on the effects of state and local public expenditure for various broadly defined functions on measures of aggregate economic growth. In some of the most important studies, Federal Reserve economists have researched the effects of the stock of infrastructure (which, as measured, reflects the historical spending record) on growth. It is fair to say that the skeptics seem to have had the best of the argument so far with respect to infrastructure, but that may be mainly because the aggregate measures of infrastructure spending or stock for states as units of observation are unsatisfactory in various ways. Ideally, the independent variable should be a measure of the overall quality (as perceived by users) of the *services* provided by each major component of infrastructure, not the level of spending over a period of years or the depreciated replacement costs of the present stock of capital in the form of infrastructure.<sup>16</sup> The expenditure-based data probably vary among states in ways that are quite different from the ideal measure.

Bartik (1991) reviews the findings of nearly thirty studies of the effects of difference in “public services” on business location, in addition to the infrastructure stock studies. Public services sometimes are measured by physical quantities (such as mileage of highways per square mile of area) but mostly by expenditures per capita or as a percentage of personal income. In six of the studies, expenditure for schools had a positive and significant effect on the dependent variable; in three studies, police and fire expenditures had such an effect; in three studies, highway expenditure or physical stock had that effect; and there were positive and significant coefficients for health in two studies and for higher education in one. Fourteen studies drew

blanks, that is, positive coefficients that were not statistically significant or negative coefficients. These findings hardly make a strong case for spending more money on broad categories of public services as a route to economic growth in a state or urban region.

It should be obvious why more spending for public services that are in fact logically connected with economic growth—infrastructure and human capital—seems to have so much less impact in advanced countries than in developing countries, where the impact can be huge. Take transportation, for example. In a mountainous developing country, the road between the capital and a town twenty miles away may be so bad that there is no motorized transport between the two places, and the town is effectively isolated from the national economy. Rebuilding the road to permit the use of buses and trucks reduces trip time from all day to one hour each way, converting the town into a component of the capital's market area. However, in an advanced country, the road network permits motorized travel from every point to every other point within the country and travel on rather good roads every place in urban regions. An immense investment program, such as \$100 billion over five years, is likely to yield an infinitesimal improvement in aggregate accessibility measured, say, by the percentage reduction in mean travel time per trip for all types of trips weighted by the value of different types of trips: mean trip time may decline from 25 minutes to 24.98 minutes. This does not mean that the investment program is unwise, only that we should not determine its wisdom largely on the basis of its contribution to aggregate economic growth, which is likely to be below the threshold for measurement.

As the comment above about the hostile treatment of trucks and other business-service vehicles in highway policy in the New York area suggests, this is not to say that well-considered public expenditures cannot have positive economic development effects. Much of the criticism of the conditions at and access to Kennedy Airport over the years has been based quite explicitly on concerns for the negative effects on the region's economy. There is non-anecdotal evidence about the effects of quality of services: two recent articles (Button et al. 1995; Wassmer 1994) report empiri-

cal findings that suggest that public spending can have significant effects when the spending produces real differences in the quality of transportation and other publicly provided services.<sup>17</sup>

#### TAX POLICY AND ECONOMIC DEVELOPMENT

On the tax policy side, the choice between general and selective economic development measures is less clear cut, at least in New York. Hindsight reveals some fairly large errors in tax policies in New York that were implemented largely for economic development reasons over the past fifteen years, whether those policies were across the board or selective. There has been no discernible effect of the general investment and employment incentive provisions in the corporate income taxes, according to repeated studies covering a considerable span of years by the New York State Legislative Tax Study Commission. The very large as-of-right property tax reductions in New York City designed to produce more yuppie housing (the condominium and co-op conversion aspects of the so-called J-51 program) in the late 1970s and early 1980s—as an economic development measure, not to subsidize housing as such—appear to have given away far more than was necessary to elicit the investment: generally, the resulting rates of return were very high indeed.<sup>18</sup>

The highly selective, often very large, reductions in property taxes negotiated with corporate developers of specific large office buildings throughout the 1980s and 1990s have also been highly inefficient in numerous cases, either because after the fact it became clear that the tax preference was far in excess of the taxpayer's reservation price or because the firm subsequently reneged on the employment guarantees that were part of the negotiation—sometimes not increasing employment as promised and, in at least one well-publicized case, simply moving away from the city a few years after the deal was signed and the building put up.

Nonetheless, some of the negotiated deals seem in retrospect to have been exactly right, for the time and circumstances, giving away in taxes almost exactly what was required to elicit the investment decision at that time. The



more dire the circumstances, the more likely this was the case. Thus, the deals that now look most justified are those made for central business district projects in the dismal late 1970s, when the recovery was just beginning, and those made for projects outside the central business district, in locations that had been decidedly unattractive to office developers.

However, on balance, well-designed changes in tax policy seem less error prone than selective tax preferences. On this issue, we have the results of a generation of studies of tax levels and economic growth to use as a basis for choice among policies. Bartik (1991) reviewed 123 separate studies of the effects of tax levels on business activity. The studies were published between 1980 and 1991 and for the most part relied on data from the 1970s and early 1980s. Almost 100 of the studies were inter-area (state or metropolitan area) in focus; the rest focused on changes and differences within states or within metropolitan areas. They differed widely with respect to the dependent variable—the measure of economic activity or growth—but fifty of the studies were confined to manufacturing variables of one kind or another.<sup>19</sup> The tax variables also differed greatly: most employed some aggregative measure such as state and local taxes on a per capita basis or as a share of personal income or gross state product, while the others used effective tax rates for one or a number of taxes.<sup>20</sup>

Ninety of the 123 studies reported at least one statistically significant negative tax effect. The reported long-run elasticities of business activity with respect to taxes clustered in the -0.2 to -0.4 range for the inter-area studies, with the studies that employed controls for public spending levels and/or “fixed effects” generally having the higher figures. As would be expected, the intra-area studies tended to find much higher elasticities, usually -1.5 or higher.

What do these results tell us? They provide overwhelming evidence that taxes do matter in location, something that was disputed by most economists and many politicians twenty years ago.<sup>21</sup> They also show that taxes matter a lot: if state and local taxes in a state amount to 12 percent of gross state product (GSP), close to the New

York level, and the elasticity is -0.4, a \$1 billion reduction in the overall level of taxes in that state should increase GSP over time by \$3.3 billion. However, the results also indicate that the tax cuts will not pay for themselves in budgetary terms unless (1) the higher rate of economic growth improbably reduces the level of public expenditure (the opposite could be the case) and/or (2) the tax reduction interacts with other events to produce a cumulative growth process that is not entirely attributable to the tax policy changes as such.

Some of the studies reported by Bartik suggest the possibility of stronger effects in this region. Some of the intra-area studies with high elasticities were not studies of a single metropolitan area or region, but of whole states (including large ones) or of one large city compared with the rest of the country. This geography has some relevance to the New York region's competitive position within the northeastern United States. Also, most of the studies in which the independent variable was the effective rate of one or more taxes paid by business firms tended to have higher elasticities. Because such taxes are very high in this region (relative to the rest of the United States, not necessarily relative to major competing cities in other countries), it is conceivable that policies focused on reducing those taxes would be self-financing over time.

#### PROMISING TAX STRATEGIES FOR THE REGION

Economists like to write as if state and local governments face absolute budget constraints and therefore cannot stand tax cuts that are not fully self-financing. This is of course true in the long run, but not necessarily in the short run. However, given the fiscal history of state and local governments in this region over the past quarter century, even short-run budget deficits are not really tolerable—and probably would have damaging effects on the location of economic activity since the deficits would guarantee that tax rates would have to rise and/or expenditure levels would have to be cut quite soon. So, although we may be persuaded that what the region needs is to reduce its overall tax receipts as a percentage of GSP to the national average level and that in this region the long-run elasticity of

GSP with respect to taxes may be a very high -0.6, it is impossible to imagine how one could manage the needed reduction, about 20 percent of total revenue from *all* taxes, state and local, for the three states combined.<sup>22</sup>

This quandary suggests that the targets for tax reduction in the region should be those tax instruments that affect business costs fairly directly and entail very high rates but are not the most important revenue producers, rather than broad-based rate cuts in the major taxes—not a very populist political strategy. One example is reform of the state and local taxation of utility-supplied energy and telephone services to business customers, taxation that is extraordinarily high in New York State but somewhat above the national average in the other two states as well.<sup>23</sup> Another example would be the removal of most intermediate business purchases from the scope of the sales tax. The region's states do have some rivals in other parts of the country in the assiduous effort to convert the sales tax from a consumption tax to one mostly on business inputs, but many of those rivals are states with lower sales tax rates. We combine high sales tax rates and broad coverage of business inputs (but not particularly broad coverage of consumer goods and services).

There are some seemingly plausible targets that have been singled out by tax study commissions and tax reform programs in New York City time and again: notably, the city's tax on unincorporated business income and its tax on commercial rents. Although these taxes are conspicuous because they are unique to New York City, they are not especially damaging tax instruments, despite their bad reputation.

The unincorporated business tax (UBT) is one on the net income from business or professional activities conducted within the city, imposed at a rate of 4 percent and applying only to proprietors and partnerships once their incomes exceed \$30,000. Residents pay this tax in addition to the ordinary resident personal income tax. Why does New York City have such a tax when no other place does? When New York City thirty years ago requested and received authority from the state legislature to impose, for the first time, income taxes on individuals and businesses, the legislature insisted that the city income taxes mirror

the state income taxes, which then included a tax on unincorporated business. In the late 1970s, the state UBT was abandoned. However, the city budget never seemed to have enough leeway to permit the city to give up a tax that yields about \$400 million annually.

So, why did New York State, alone among the states, ever have a UBT? The answer lies in the unusual structure of the New York City economy. In most states, the corporate income tax embraces a very large share of the state's economy, except for agriculture (which no legislators like to tax, anyway). To be sure, there are many unincorporated businesses, but they tend to be very small in other states. However, some of the most important industries traditionally have operated here in the noncorporate form of partnerships, even when the enterprises were very large. Securities firms all were unincorporated for decades and even now many big ones remain partnerships. This is true in other aspects of finance as well. Almost as important is the organization of large law, accounting, and other professional firms as partnerships. So, in New York State, to tax only the income of corporations was to ignore the income of some of the most important and most profitable sectors of the economy.

This consideration is even more important for the city than it is on a statewide basis. Another argument for continuing the city UBT even after the state repealed its UBT has been the awareness that many of the high-income principals in financial and professional firms live outside the city. If there were no UBT, the city's tax system would not reach that income. The city personal income tax is on residents only. The city's nonresident earnings tax has an extremely low rate. In addition, by definition, if an enterprise is not incorporated, it is not subject to the corporate tax.

The criticism of the UBT is that it comes into play only when small enterprises start to become successful. According to some observers, the city may be a good place for new small businesses to get started, but as soon as they start to make it, the city government slaps them with the UBT and other taxes, inviting them to depart to lower tax, greener pastures.

Who does pay this tax? Not the newly maturing incubator industries, as the critics would have it. Accord-

ing to the New York City Department of Finance, large partnership enterprises in finance, law, and other services to business accounted for 72 percent of the payments in 1993. Another 14 percent was paid by doctors and other health care providers. The quintessential small businesses that politicians tend to worry about—in retail trade, manufacturing, and personal services—accounted for 14 percent of the tax receipts and about 7,000 of the 30,000 UBT payers. The Department of Finance is able to identify the residences of the taxpayers who account for about two-thirds of the tax revenue: just under half this amount was paid by commuters, 27,000 partners in taxpaying partnerships, and 9,000 individual proprietors.

Thus, the tax does seem to hit the targets it was designed to hit: businesses mainly in finance that provide services to other businesses, play an important part in the New York City economy, and would otherwise escape, to a considerable extent, the city's taxes based on net income. It would seem a strange strategy of economic development to substantially reduce income taxes on large firms in industries for which the city and region still have strong locational advantages.

The tax on commercial rents, which is paid directly by the renters themselves, began decades ago as a minor, low-rate tax. The rate was greatly increased in the 1960s and 1970s, converting the tax to an important revenue producer. After the fiscal crisis, exemption levels were increased, rates were reduced for commercial premises outside the Manhattan central business district, and finally the tax was eliminated for the city outside the central business district, as an economic development measure. Here, too, the critics of the tax view it as an oppressive burden on small businesses that are struggling to survive or expand in the city.

That view confuses legal liability for the tax with its economic incidence. At any given moment, the supply of rentable commercial space is to a considerable extent fixed and can change only over a period of years, while the demand schedule for the space is entirely independent of the actions of property owners and tax collectors. Under such circumstances, it is impossible to imagine a scenario in which an increase in the tax will raise the gross space

occupancy costs to tenants or a decrease will lower those costs, except in the very short run. When new leases are negotiated, renters surely will consider the commercial rent tax liability change in making their offers to building owners, who will be entirely aware of the tax change. For example, when the market for midtown Manhattan office space is strong, as at present, repeal of the commercial rent tax would result in higher rents at renewal than would have been the case were the tax still in effect; in lower Manhattan, with a weak market, rents at renewal would not be reduced as much as otherwise would be necessary to clear the market. The net effect of repeal would be to increase the capital value of the property, with little or no effect on economic activity.<sup>24</sup>

There are some parallels between the commercial rent tax and the high property taxes on commercial real property (relative to residential property) that are the general rule in New York City, Nassau County, and other places in the region. If the commercial property tax were highly uniform among individual properties within a city or other taxing jurisdiction, that is, highly correlated with some market measure of value—as the commercial rent tax is with market rentals—it is not evident that a uniform reduction in the tax would have much of an economic development impact. At least one simulation study has shown that a large across-the-board reduction in commercial property taxes in New York City would have only a negligible positive effect on total employment in the city.<sup>25</sup>

However, the commercial property tax is rarely uniform among individual properties. Usually, in the absence of property tax abatement programs or deals, the effective rate of property taxes on new commercial buildings is considerably higher than the rate on most older buildings that are not functionally obsolete or in unfavored locations. That is, the decision to raze an older, smaller building and replace it with a newer, larger one may trigger a very large tax increase, entirely disproportionate to the difference in market values. In part, this is because the assessor then revalues the site from a level far below its market value to a level more closely approaching that value, an action that is considered improper professional

conduct (the market value of the site has not changed) but is common nonetheless. In any event, the higher the level of tax, the more likely it is to be a deterrent to new investment. At the extreme, this can produce a situation in which no new commercial construction is feasible without tax abatements.<sup>26</sup>

The elimination of discriminatorily high taxation on new buildings in general would have positive incentive effects, and could sensibly substitute for negotiated abatement deals, given the spotty record of the latter. However, there is another, and much more powerful, way to increase the incentives for new construction: It is high time that serious consideration be given to land-value taxation, as a substitute for all or part of the property tax on structures (and perhaps for some other taxes as well). Economists are well aware of the theoretical virtues of land-value taxation. Unlike every other tax, actual and conceivable (other than a head tax), the tax is entirely neutral with respect to economic decision making.<sup>27</sup> Differentials in tax rates will not affect the location of economic activity, unlike all other taxes, nor affect the choice among conceivable uses of specific sites. The burden of the tax is borne by the owner of the site at the time the tax is imposed or increased: it cannot be shifted to any other economic actor. That makes the incidence of the tax as progressive as any conceivable tax because the elasticity of the value of urban land ownership with respect to income is positive and very high.

In reality, taxes on land values are significantly lower than those on the value of structures in nearly every place in this country, and markedly so in nearly all the most urbanized parts of this region (as well as in some of the less densely developed sections, such as eastern Suffolk County). This is visible in the very low assessments of vacant land, in the assessments of land that is sold for reuse, and in the low assessments of residential parcels in prime neighborhoods. Why land is so favored, and has been for so long, is something of a mystery, not fully explained by the undoubted power of large landowners in state and local politics or the thorough misunderstanding of the likely consequences of land-value taxation for most owners of modest houses. One part of the explanation may be the lack of good empirical evidence on the results of

heavier taxes on land value than on structures, in places and at times that are relevant to American urban regions today. Century-old experiences in western Canada, Australia, and New Zealand are not very persuasive.

There has been a good recent study of an experience that is relevant to the New York region today (Oates and Schwab 1995). Since the 1920s, the city of Pittsburgh has imposed higher tax rates on land value than on buildings (a number of smaller Pennsylvania cities have done so for shorter periods). Until 1980, the tax differential in Pittsburgh was quite small, but it was increased very sharply in 1980. Pittsburgh experienced a very impressive central city construction boom during the 1980s, one of the highest rates seen in American cities. Oates and Schwab studied the relationship between the tax change and the level of commercial construction using a long list of large American cities for comparison, and concluded that the property tax changes were probably responsible for a considerable fraction of the new investment. Economists would have predicted this, but now the prediction has been substantiated.

The careful reader will note that my list of plausible tax strategies does not include what has been the most popular tax policy strategy for economic development in New York for the past thirteen years and more recently in other states: repeated reductions in the rates of the state personal income tax. This has been an extremely costly strategy, and the only evidence of its effectiveness lies in the strident assertions of its proponents. Of the 123 studies examined by Bartik, in only a single instance were differences in personal income tax rates significant (and negative): a study of Philadelphia's extremely high local income tax by Robert Inman.<sup>28</sup>

The assertions of the proponents of personal income tax reduction as a serious economic development strategy are implausible. First, the proponents claim that people with high incomes from capital will avoid living in a high-tax state, thus adversely affecting consumption spending and, allegedly, making the decision not to locate enterprises they control in that state. The classic example used is the location of plants and corporate offices during the 1970s and 1980s in Fairfield County rather than in

Westchester County, two counties that are quite similar in numerous respects. Even if true, this has to be an isolated effect, and one that will be less important over time. Second, it is asserted that high personal income taxes will require firms in that state to pay higher wages, to the extent that the firms compete nationally (or internationally) for labor or certain types of labor, and to offset the indirect effects of high state taxes on wages and prices in consumer-serving industries in the state.

We academics operate in national labor markets and are well aware that tax differentials affect the compensation that must be offered; the question is the size of the effect, not its reality, for the economy as a whole. If high local taxes and living costs for key staff people were the major determinant of location, there would be few American firms opening offices in Tokyo, Zurich, Frankfurt, and Paris, where living costs (including local taxes) for American expatriate staff are enormously higher than they are in New York. Simple calculations suggest that in most cases the higher levels of compensation for key staff people required in the high personal income tax states must be a very small fraction of total costs.

#### ECONOMIC DEVELOPMENT PROGRAMS

##### AND "NEW WAVE" POLICY INSTRUMENTS

Earlier, I alluded to the general failure of explicit, highly selective economic development programs that worked on reducing input costs by providing cheap credit or by subsidizing worker training. Aside from tax incentive measures, which informally date back to the colonial era, the use of the borrowing powers of state and local government to subsidize credit to private enterprises in the interests of economic development is the oldest of state and local government economic development measures. Before the Civil War, the states lent money on a large scale to canal and railroad companies and to organizers of banks, usually with unhappy financial results. By the late nineteenth century, most state constitutions were amended to prohibit such lending.

In 1936, however, the Mississippi constitution was amended to authorize the issuance of general obligation bonds by local governments to finance construction of

manufacturing plants. Within a few years, a number of states imitated Mississippi, but they used revenue bonds as the financing mechanism. By the end of the 1960s, nearly all the states were doing this, often not because of any great enthusiasm for the approach, but because their competitors were using it. The subsidy, of course, was from federal funds: the exemption of interest on state and local bonds from federal income taxation, especially valuable in an era of very high marginal income tax rates.

It soon became obvious that this form of inter-jurisdictional competition was a zero-sum game from a national standpoint, and possibly even from a state standpoint, once all states were doing the same thing. Federal tax legislation from 1969 onward has progressively limited the size, volume, and purposes of state and local borrowing for economic development that qualify for income tax exemption. The change has reduced the charms of the approach but has not eliminated some instances of major state and local bond issues, sometimes taxable under federal law, that are said to be economic development measures. The most notable are the bond issues to build new facilities for major-league commercial sports; benefit-cost analyses by economists almost always show these to be bad ideas, even from the local standpoint.

In the 1980s, a number of studies evaluated a broad range of credit and other state and local economic development incentives.<sup>29</sup> Benefit-cost ratios seldom reached 1.0, and even when the ratios passed that threshold, it was not by much. In other fields—such as infrastructure investment decisions—benefit-cost ratios of 2.0 are considered quite marginal. Systematic econometric analysis of these incentives is very difficult because the policy variables differ so much from place to place. Moreover, many of these incentive programs are very small, yielding effects that are likely to be below the measurement threshold.

In the 1970s, a new concept in economic development programming emerged: the enterprise zone. (The name of the idea changes over time; the cynic will say that this alone suggests that the proponents have little confidence in the efficacy of the programs, hoping that a new name will mask the disappointing results of the previous generation of programs.) The essence of the notion is the

identification of a relatively small geographic area as a target zone for economic development and the availability of a wide range of incentives to encourage firms to expand (or newly locate) their activities within the zone. Sometimes the target zone is one in which there was significant economic activity in the past but where that activity has declined substantially. Sometimes the target zone is simply one in which poor people live. The development of research parks is a form of very upscale enterprise zone.

In concept, the enterprise zone is a more promising approach than conventional economic development programs simply because of the spatial concentration, that is, the likelihood that the program size will be larger relative to the target economy and the possibility that economies of agglomeration can be developed (although the target zone can be quite large in big cities, such as the new Harlem–South Bronx “empowerment zone” in New York City). Few successes, however, have been reported. Bartik lists nine studies of enterprise zones and research parks published between 1984 and 1991: three reported mildly positive and significant effects, four reported no statistically significant effects, and two reported that things turned out worse in the enterprise zones than in control areas.

Although some politicians remain captivated by the enterprise zone concept, more sophisticated interventionists write in glowing terms of “new wave” economic development policies pursued by rising “entrepreneurial state” governments, described by Bartik as “an eclectic group of policies that became popular in many states during the late 1970s and early 1980s. These policies encourage various forms of innovation, such as applied research, industrial modernization, entrepreneurship, and business expansion into export markets. They also have in common a willingness to involve government much more with business decisions. Rather than just providing cash, they would have government provide services to businesses to help them determine their best market or technology” (Bartik 1991, p. 5).

Any number of rude comments can be made about the concept, such as the evident misunderstanding of the role of the Ministry of International Trade and Industry in Japan or the fact that they seem to have slept through the

collapse of socialism all over the world. A more polite response is that we have yet to see any American state that has had great recent economic success that can be attributed to these new wave programs. Even the advocates admit that they have no real evidence for their propositions.

## CONCLUSION

Surely, it would be best if public policies in the New York region were simply neutral at the outset. As Assar Lindbeck, long-time chairman of the selection committee for the Nobel Prize in Economic Science, wrote concerning national economic development policies in Sweden: “It is not by planting trees or subsidizing tree planting in a desert created by politicians that the government can promote...industry, but by refraining from measures that create a desert environment.”<sup>30</sup> However, it is not possible to recreate a verdant environment without hostile policies in the New York region, so some intervention is necessary, if only to create oases in the desert.

Still, one can dream about what that verdant environment might look like. It would be a place with drastic reductions in the costs of both construction and everyday existence for both the public and private sectors, reductions that would clearly require a long list of changes, institutional and behavioral, on the supply side. However, it is not all that clear what a full list of the required changes would include. The occasional efforts that are made by both journalists and policy analysts to explain fully the differences in costs in a specific situation seldom are successful.<sup>31</sup>

Nonetheless, if enough people in the region were convinced that our economic future depended on a comprehensive menu of cost-reducing changes, only some of which are matters of public policy and practice, the desert could be pushed back significantly. This could occur, for example, by tort law reform, by drastic deregulation of many aspects of economic life (not just the politically easy ones such as utility deregulation),<sup>32</sup> by real enforcement of laws requiring civil behavior in traffic (to reduce transportation costs, by matching the levels of enforcement everywhere outside the Northeast) and in other situations (such as the enforcement that is lowering the costs of commercial

trash removal in New York City right now), and by comprehensive use of part-time employees for jobs that should not require eight-hour shifts, notably transit operators and school bus drivers.

An encouraging sign that economically destructive habits can change even in this region lies in the recent instances in which public and private decision makers seem to have concluded that the region has something to learn

from what is done elsewhere in North America, after at least 150 years dominated by contrary views. We are beginning to see retail stores, for “convenience goods” as well as “shopping goods,” that are efficiently sized (long after the rest of the country), and to hear that transit officials in the region are consulting with transit operators elsewhere about the design of subway cars. Such developments have to be good.

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## ENDNOTES

1. See Netzer (1974) for a discussion that reflects the tenor of those times. The state of the New York economy and how that affected public policy over the past thirty years are reviewed in Netzer (1990).
2. See Sleeper (1989) for a volume of essays first published in *Dissent* in 1987. Six of the first eight essays attack city economic development policies as unneeded, and worse.
3. The study was conducted by the Harvard University Graduate School of Public Administration for the Regional Plan Association, under the direction of Raymond Vernon, between 1956 and 1959. The results of the study appear in nine substantive books and one technical monograph. The capstone is Vernon's 1960 book.
4. See Netzer (1969) for a contemporary account of the validity of the Vernon forecasts. Netzer (1985) also examines the Vernon forecasts at the end of the forecast period. The projections of the national economy in the Vernon study did not foresee the reduced role of manufacturing over the period, but adjusting for that failure—which was common to all long-range forecasts in the 1950s and 1960s—the Vernon projections for the New York region were surprisingly on target.
5. Specific projections consistent with the views expressed here were developed by the Regional Plan Association (RPA) in 1988 and 1989 for the Metropolitan Transportation Authority. The more recent RPA projections, which are the basis of the "Third Regional Plan" (see Yaro and Hiss 1996), are much more pessimistic and internally inconsistent in numerous respects; the economic projections seem designed mainly to sound a cry of alarm in support of policies that RPA espouses independently of their consequences for the region's economy, such as the enormous investment of public funds in rail transit.
6. A simple example, for a relatively short period, makes the point: the motor vehicle manufacturing industry between 1980 and 1992. Had the actual 46 percent increase in hourly productivity and the actual 3 percent increase in employment been correctly forecast, the forecaster might have guessed that output would increase from 8.0 million cars and trucks in 1980 to 12.0 million in 1992. The actual increase in units produced was much more modest, 9.7 million. Obviously, each unit embodied substantially more product in 1992 than it did in 1980. However, it is improbable that the 1980 forecaster would have so specified the results.
7. The work Glaeser refers to includes the following papers: Rotember and Saloner (1990), Topel and Ward (1992), Becker and Murphy (1992), Rauch (1993), Glaeser (1994), Glaeser and Maré (1994), Ades and Glaeser (1995), and Glaeser (1995).
8. Moreover, there are apt to be widely separated clusters of office buildings, as in Atlanta, rather than tight clusters in central business districts.
9. The WEFA (Wharton Economic Forecasting Associates) model results that the RPA relied upon in work done for the Metropolitan Transportation Authority in 1986 and 1987 had female labor force participation rates virtually equal to male rates among New York City residents by 2005, a projection that was not credible. Such a result requires either that very few women with children remain outside the labor force during the child-rearing age, or that the unequal distribution of child-rearing duties by gender be offset by women retiring at later ages than men (which is the opposite of the current situation in this and every other advanced economy).
10. Perhaps the best case made for this side of the debate appears in Eisinger (1988).
11. Bartik also reviews the results of the small number of studies dealing with two aspects of regulation: environmental regulation and banking regulation.
12. The best analysis of this question is found in Small, Winston, and Evans (1989). To simplify, there are two types of costs entailed in the provision of the road system: road surface wear costs and congestion costs. The former differ among vehicles with the cube of the weight on each axle, above a threshold that includes passenger cars, virtually all light trucks, and some heavier trucks that have multiple axles; below the threshold, road wear costs are zero. Congestion costs differ among vehicles almost entirely on the basis of time of day and direction of travel; size has almost nothing to do with these costs. So, charging light trucks registration fees and tolls that are a multiple of the charges imposed on passenger cars is nothing but price discrimination, as is charging multiple-axle rigs with relatively modest axle loadings far more than smaller heavy vehicles with few axles, such as ready-mix-concrete trucks and dump trucks.
13. An excellent example is the immunity of the New York City Fire Department to retrenchment in times of budgetary difficulty throughout the past twenty-five years, despite clear evidence that appropriate spatial deployment of firefighters (that is, closing many firehouses and opening a few new ones in better locations) would permit both reduced response time and drastic staff reductions. The proposed closing of *any* firehouse immediately produces a local uproar, which elected officials will not face down.
14. These are my own estimates, as of fiscal 1994, based on data from various official documents, especially the New York City Comptroller



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## ENDNOTES (*Continued*)

### *Note 14 continued*

(1994) and the New York City Department of Finance (1995). The target ratio of assessed to market value for property classes other than homeowner properties is 45 percent, which would yield effective tax rates of 4 to 5 percent for those classes. However, that ratio is seldom achieved for existing properties because of restrictions in state law and administrative lags in reassessment.

15. For a package of such policies, see Netzer (1992). Converting tolls into cost-based congestion charges is one of those policies (see endnote 10).

16. Depreciated replacement cost is the concept used by the Bureau of Economic Analysis in its application of the “perpetual inventory” method to value tangible, reproducible fixed capital.

17. Kenneth Button, a transportation economist, and his colleagues, reporting the results of a large-scale study of location in the Strathclyde region of Scotland, conclude that differences in local transport quality within the region constitute an important independent variable. Wassmer, in an empirical study of location in eastern Michigan cities, finds that most local incentives have no “additive effect” but some spending variables do, depending on city-specific characteristics.

18. Eventually, the program was confined to the outer boroughs and the nonaffluent part of Manhattan, thus becoming an ordinary middle-class housing subsidy, not an economic development measure. For an analysis that demonstrates how wasteful the program had been, see White (1983). This analysis was one of the few entirely unambiguous *ex post facto* empirical studies of tax incentive programs, because the author had actual before and after sales prices to compare.

19. Presumably, the reason was partly that the data on manufacturing for small areas are abundant and rich in industry detail and partly that within a detailed industrial category, there is a good deal of homogeneity across places.

20. Most of the intra-area studies used the property tax rate as the tax variable. The studies by James and Leslie Papke, however, used the effective tax rate for all state and local taxes combined, simulated by industry from their AFTAX model. This tax measure is far and away the best conceivable.

21. The economists’ position was absurd: The appropriate statement at the time was that we had been unable to find convincing empirical evidence of the strength of the tax effects, not that the effects were absent. A 1961 article by Harvey E. Brazer, well known to most public finance economists, put the argument properly, reviving an analysis first presented to a royal commission by Alfred Marshall a century ago.

However, it took the improvement of data for small areas, the development of adequate econometric techniques, and (most important) the training of generations of well-equipped inquisitive economists to produce the empirical verifications. The process is a testimonial to the validity of the old-fashioned idea of scientific progress.

22. In the early 1990s (the latest period for which the necessary data exist), state and local taxes in New York State as a percentage of GSP were about 35 percent above the national average, those in New Jersey were about 10 percent above the average, and those in Connecticut were just below the national average.

23. Among the distortions caused by current tax practices is the choice between fuel oil and natural gas as a source of energy, the former bearing much lower taxes because it is not supplied by entities defined as utilities. Fuel oil is not a significant source of energy for space heating anywhere in the United States outside the Northeast.

24. In an office building construction boom, repeal of the commercial rent tax very likely would heighten the boom by encouraging more speculative building. However, more empty office space (when the boom ends) is not a valid objective of economic development policy.

25. See New York University (1980). The study simulated the results of classifying all taxable property into one of two classes—housing and business—and equalizing effective property tax rates between the two classes, an approach that produced a uniform 20-odd-percent reduction in taxes on all business properties. The study did not deal with the consequences of more within-class uniformity. Because the overall effective tax rate was unchanged in the simulation, the conclusion in this study does not conflict with the view held by most public finance economists on the results of reductions in overall rates in a single city on the migration of capital among cities and regions (see Heilbrun [1983]).

26. In the city of Boston from the 1930s until 1960, there were no new office buildings or hotels constructed, because such buildings would have confronted an effective property tax rate of 10 percent, at least three times as high as the comparable rate for new office buildings in *any* other U.S. city at the time. Construction of new commercial buildings began only after passage of a state law that provided for a tax of 10 percent of gross rents, not value, for new buildings in designated urban renewal zones—such as all of Back Bay and the South End.

27. There is one exception extensively discussed in the literature. Unless the tax base is properly defined, the tax is likely to affect the timing of development of sites and therefore have some distorting effects on economic decisions.

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## ENDNOTES (*Continued*)

28. There was another study in which personal income tax rates were significant, but the coefficient was positive, a thoroughly implausible finding.

29. These studies are discussed in Netzer (1991).

30. Quoted in the *Economist*, March 3, 1990, p. 17.

31. For example, when one tries to explain why retail gasoline prices are so high relative to prices in other places on both the East and West

Coasts, even in parts of the New York region where land values are low, it is discovered that obvious variables such as state and local taxes and wage rates leave large unexplained differences. Even the addition of more subtle factors such as wage rates and restrictions on the size of underground fuel tanks and tank delivery trucks do not clear up the mystery.

32. A few places in the country, notably the state of Arizona, have completely deregulated taxi service. What would taxi fares be without restriction of entry, so that the cost of amortizing the medallion was zero?

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